DOW THEORY LETTERS INC.

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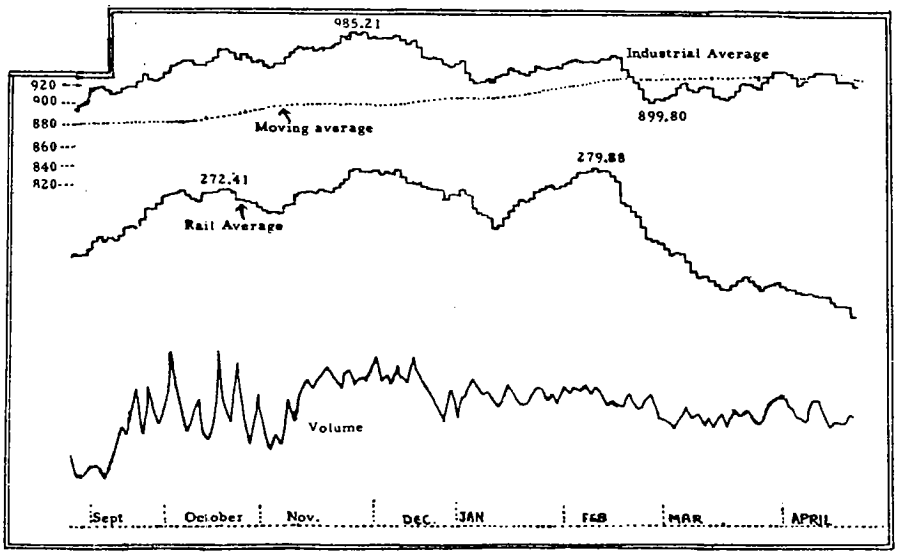
THE MARKET: No one can believe the resistance this economy (really the America people) has to believing that inflation is in trouble. In the latest letter from the First National Bank in Dallas, the bank's astute economist states: "Early in the year my prediction was that the worst would be over by May. Now May is only two weeks away. It was a bad guess! But I am really undaunted and am willing to go out on another limb by merely moving the time forward to summer. By then we should see tangible results from the tough fiscal and monetary policies being used."

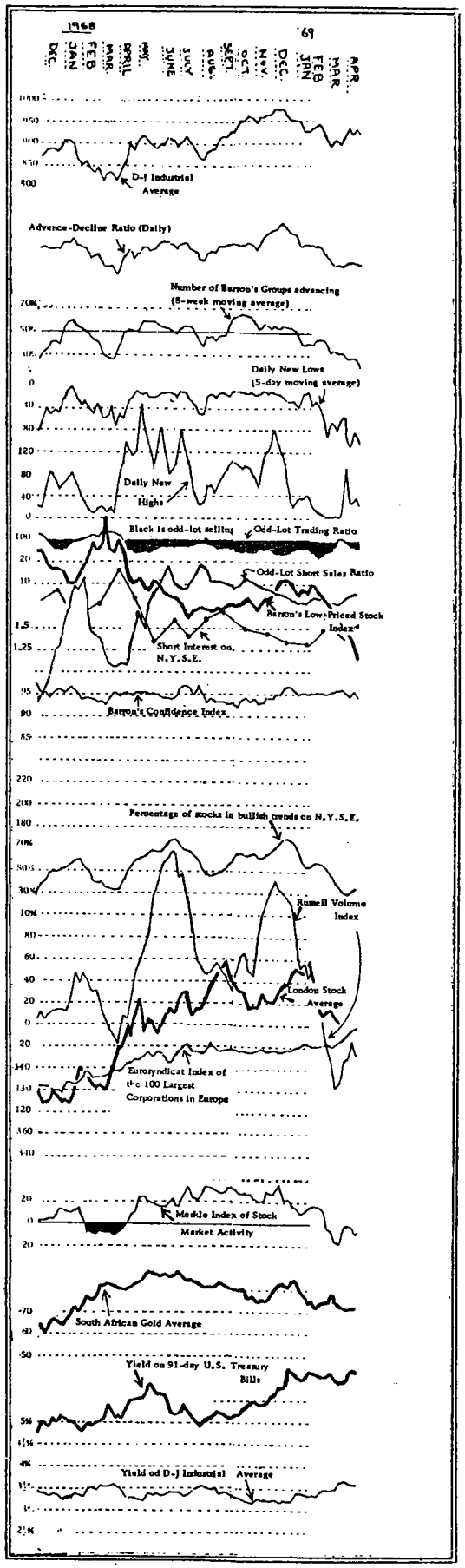
So it goes. Inflation stays with us like a plague, and the Administration daily ponders whether and when it will end. I sense that fate is playing with the America economy much as a cat plays with a mouse. There's the pawing, the teasing, the hopes, and then the kill. I believe that is what is in store for inflation in America.

I feel that within a year it will be deflation which will be worrying our leaders. Within a year they will be wondering why stimulants and more stimulants can't turn the market and the economy around. The same stubborness which will not end inflation will then be working in reverse, and the price of everything will begin to sink, regardless of what the Administration, the Federal Reserve or the Treasury want.

In a leading market report received here today I read, "But this time, we are confident that the Fed will be successful in slowing inflation because it can work uninhibitedly towards its goal, knowing that should a mishap occur that could bring the country to the brink of depression, the situation could be instantly remedied." Although I have great respect for the author, I do not agree that it will be all that easy. I remember Robert Rhea's words, "Government with all its power can't control the Mississippi River, much less the tides of American business or sentiment. Government money policies, if constructive, can help a bull market, but can't stop a bear market."

Most of the writers around today are writing from experience—and there, I believe, is the catch. They are writing from their own experience through the greatest bull market in history, 1949 to 1966. A single example does not make a series, nor does it provide real experience. There is no way of experiencing a great bear




1968
69
D-J Industrial Average
Advance-Decline Ratio (Daily)
Number of Barron's Groups advancing (8-week moving average)
Daily New Lows (5-day moving average)
Daily New Highs
Black is odd-lot selling
Odd-Lot Trading Ratio
Odd-Lot Short Sales Ratio
Barron's Low-Priced Stock Index
Short Interest on N.Y.S.E.
Barron's Confidence Index
Percentage of stocks in bullish trends on N.Y.S.E.
Russell Volume Index
London Stock Average
Eurosyndicat Index of the 100 Largest Corporations in Europe
Merkle Index of Stock Market Activity
South African Gold Average
Yield on 91-day U.S. Treasury Bills
Yield od D-J Industrial Average

market except living through a great bear market. I believe we are experiencing the early stages of a mighty primary bear trend now. This will provide lesson number two for the analysts.

A study of the big picture is now in order. I have included a chart showing the action of the D-J Industrial and Rail Averages from 1962 to present. As far as Industrials are concerned, all the primary action occurred between February and October, 1966. During that period the bull market topped out with Industrials at 995.15, following which a primary decline took Industrials to a bear market low of 744.32. Two mighty upward thrusts ensued, the first taking the Dow to 943.08 in 1967, the second taking the Dow to 985.21 in late-1968. Since then, Industrials have drifted back towards the 900 area.

The rails, since their 1965 peak of 271.72, established two successive unconfirmed highs. The first occurred in 1967 at 274.49, the second came in 1968 at 279.48. From the standpoint of Dow's Theory, the new Rail highs were meaningless if not actually deceptive, since neither was confirmed by a new Industrial high above the 1966 peak.

The action since the recent December, 1968 peaks in the Averages is interesting. Rails, following a superior three-year performance, have acted worse than Industrials. At the latest reading the carriers had broken down below their 1968 summer lows. Industrials, on the other hand, are still holding above their 1969 low of 899.80, and they are considerably above their 1968 summer low of 897.51.

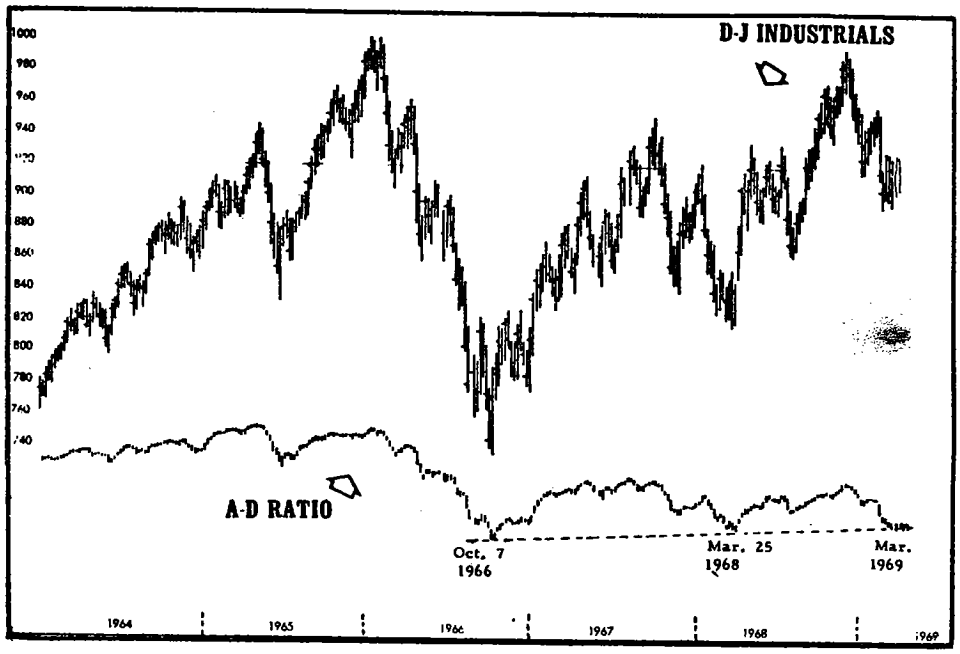
From the bears' standpoint, I feel the summer lows of 245.76 is extremely important, and I have marked these two points "X" on the chart. Rails, as stated, have already penetrated the August 11, 1968 summer low of 245.76. The August 11, 1968 summer low on Industrials is 879.51. If this bear market is to show its teeth, here are the two points to watch on Industrials. First, the 1969 low of 899.80; second, the 1968 summer low of 879.51. A penetration of the 879.51 level would show on the chart as a critical reversal of the entire advance which has been in effect since October, 1966.

For the near-term, I feel it is important to note whether the weakness in the slowly collapsing Rail Average rubs off on Industrials. If this does occur, I would guess Industrials would be at new 1969 lows (below 899.80) in a matter of weeks. A plunge into the 800's by Industrials would affect sentiment most adversely, and I believe it would start businessmen re-evaluating their 1969 capital commitments.

All in all, to the observer on the sidelines (and that is where Dow Theorists belong at this time), it is a most fascinating picture, and one which could unfold with explosive suddeness at any time. To those who are fully or partially invested in selected common stocks or bonds, the picture is more frightening than fascinating. But I calm my nerves by telling myself that these Letters are written for those who take Dow's Theory seriously, and not for those who live on hopes, dreams and the pronouncements of our leaders in and out of Washington.

ADVANCE-DECLINE: There's something eerie about the relationship between the Industrial Average and the advance-decline ratio in this market. In Letter 423 I published a chart showing the weekly plottings of these two important indicators, and I repeat that chart here again (brought up to date)— see page 3.

Note that the A-D ratio continues to flirt with its low of March 25, 1968 and its preceding lows of October 7, 1966. While the Industrials seem to resist the whole area of the 1966 low (744.32) and the 1968 low (825.15), the bulk of the market as represented by the A-D ratio is definitely flirting with the 1966 bear market low.



What will it mean if the A-D ratio penetrates its 1968 and 1966 lows? If this occurs within the framework of a primary bear market (and we are now in a bear market), I would consider it a most ominous sign. Furthermore, if the A-D ratio breaks its 1966 low I would think that there would be a very good chance that Industrials would confirm on the downside, violating first their 1968 bottom and then their 1966 bottom of 744.32.

So far on the rally since the February, 1969 lows, the general market (i.e. all issues) has shown a sluggishness, a lack of rallying power. The advance has been led by a handful of issues, mostly blue-chips, while the speculative leaders of six months and a year ago have remained in the doldrums. This is not good action. And as noted repeatedly in recent Letters, the actions of the Rail Average (which is a speculative index of its own), has been really poor.

At the slightest sign of weakness, Rails have been drifting to new 1969 lows while the Utility Average has held precariously off its 1969 low. There appears to be a weight hanging over the market, and that weight will not lift. The weight, I am afraid, is the force of the primary bear trend. It will not be lifted (except temporarily) until the primary bear forces have fully expressed themselves— perhaps a year or so or longer from now.

HOPES: As the great Dow Theorist William Hamilton often noted, "People believe what they want to believe." I cannot help thinking of Hamilton's words as I sift the daily newspapers and magazines.

(1) People want to believe that there will be no day of reckoning. With the whole nation in ferment on a dozen massive issues from racial strife to the sexual revolution, people want to believe that it will all end with everyone holding hands. Somehow, I don't think it will.

(2) People want the Vietnam war to end. Americans are tired of the war, and they hope the Communists are too. But those hopes will not end the war. In fact, I have an uncomfortable feeling that despite our new President, there is a very good chance that the war will heat up again. Hanoi shows no real sign that it is ready to talk at the peace table. Their actions show the very opposite. No great ideas for ending the war have come forth from the Administration. The communists evidence no signs that they are interested in compromise. That's what I see. Hopes do not change what I see.

(3) People hope that inflation will end, and end painlessly. I believe that inflation will ultimately end, but business and people, in their actions do not seem to believe it. They want to believe it, but they don't act as if they do believe it. For that reason, I would guess that inflation will be with us longer than the Administration thinks it will. And when it does end, I do not think the results are going to be painless "dis-inflation." In fact, I suspect that the only thing that is going to end inflation is a market crash. People believe a collapsing market as they believe nothing else. For that reason, I feel a market smash is coming.

ON AND ON: On March 28, W. K. Panofsky, testifying before the Gore Committee against the Nixon anti-balistic missile stated, "I can think of no better prescription for accelerating the arms race than by taking the position that we must prepare a fully safe counter-measure for any technically-imaginable contingency." Dr. Panovsky, a member of the President's Science Advisory Committee from 1959 to 1964, also happened to have invented certain components which will be used in the $7 billion dollar ABM program.

Previously, George Walk, Nobel Prize winner stated, "I don't think we can live with the present military establishment and its $80 billion a year budget, and keep America anything like the America we have known in the past. It is corrupting the life of the whole country. It is buying up everything in sight; industries, banks, investors, scientists— and lately it seems to have bought up the labor unions.....so-called defense now absorbs 60% of the national budget, and about 12% of the gross national product."

Nothing seems to stop the steady build-up of military expenditures, the spread of defense influence across the face of the land. And nothing seems to stop the rise of protest against what is happening. The liberals, the new left, the hippies, the intellectuals, are mounting a steady avalanche of protest against what is loosely termed the Establishment, for want of a better word.

Alienation is really what is happening. The American people are becoming cut off from their Government and from their leaders. And largely, it is that half of America which is under 25 which is being cut off from the men, the policies and the thinking which run this country.

Personally, I cannot think of anything more dangerous than this cancer which is eating at the very soul of the nation. It is a cancer which is going to lead to the most dire consequences, to a conflagration which could be unmatched in American history.

The American Establishment stands for the old values, for things as they were, for power and massed wealth and "everything in its place." Against the Establishment is the new series of explosions, as heard in popular music, as seen in the Universities, as exemplified in the new clothes, in the racial confrontation, the sexual revolution, the new speech, the new morality (which is actually the questioning of the old morality, the talking about things as they are, not as they are supposed to be).

I don't know how it's all going to end. But I do sense that it's coming to a head. Nothing as big as the present confrontation between youth and the Establishment dies or simply goes away. One can sense the old order either going out or changing. Executives in large corporations now wear beards, Life Magazine turns liberal, performers on TV quit or get fired over censorship regulations, underground newspapers become a real influence in advertising, the old-timers shake their heads from the safety of their apartments.

The Establishment has depended on inflation and prosperity to keep the new ideas and the new movements quiet. "Get off our backs," says the Establishment, "you've never had it so good." And there is something in that argument, because to some extent it has worked.

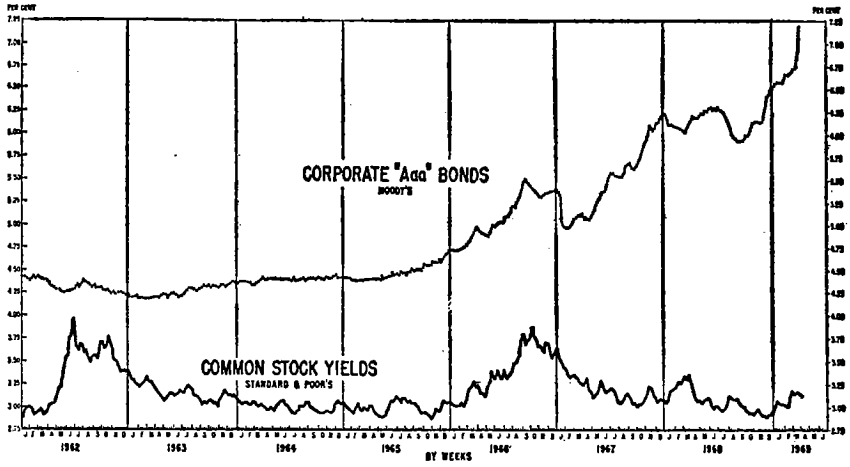
But inflation carries with it the seeds of its own destruction. And who is to say which is more degenerate, the Establishment with its $80 billion defense budget and its dreams of perpetual armaments and inflation, or the hippies who can't cope with their parents and the world and who freak out on hash, pot and anything else they can drink or smoke.

I have studied a good deal of the New Left literature, and I have studied it seriously. And I note that there is a fatal flaw in the New Left. They know what they are against, but they have no answers. They do not know what will take the place of what they are against. Just as it is not enough for the Establishment to be for the minds and mores of the 1900's, it is not enough for the New Left to be simply against those minds and mores.

I guess I am an optimist. I believe that out of the coming conflagration and chaos there will come something really good, something new, something based on human feelings and human dignity and human values. But first I foresee the fire. That, in non-financial terms, is what the coming bear market will be all about.

FOR THE RECORD: Ten days ago the negative yield spread set a new historic mark of 4.10% in favor of bonds. During that week (see chart, page 5) the yield on Moody's Aaa-rated bonds jumped to 7.22%, an all-time record. During the same week the yield on Standard & Poor's 500 Stock Average dropped to 3.12%. The difference in bond-stock yields is therefore

4.10% in favor of bonds, and I would say that this insanely negative yield spread could well stand as a landmark for years to come (unless, of course, we get a further major bond market collapse from here).



Last week Federal funds (money that reserve banks lend each other, often on an overnight basis) jumped to 7%, highest rate in history. Yields on the 91-day Treasury bills moved up just under 6¼%, or near their record high. Ten billion dollars in Eurodollars have been brought in by U.S. firms, and yields on Eurodollars rose to the 8.5% level. All over Europe, interest rates tightened up as central bankers boosted their rates in an effort to defend their reserves. In Italy, dollar-dominated bonds can no longer be sold, according to a new law. In the U.S. bankers' acceptances jumped to a record 7% bid for 180-day money. It's quite a show.

OTHERS ARE SAYING: From Joe Granville's April 18 Letter (even the lovely Ormond Beach, Florida weather hasn't lifted Joe's bearishness): "Based on all technical measurements as of April 16th, I would hazard a guess that we may be on the very edge of the precipice. All we need now for a wide open break of major proportions is a new all around low in the advance-decline line accompanied by a new Dow Theory bear signal set off by a close in the Industrials below 899.80. This looks very close."

From George Schaefer's April 19 report: "……we must not forget that the stock market is on a collision course with the harsh facts of life, and whether a rally of some sort emerges from this, or not, is immaterial. This fragile market has already had the wind knocked out of it and, like a boxer who is 'out on his feet', is simply standing there waiting for the floor to hit him — whether he falls over, or is knocked over, doesn't really matter very much."

From the latest (May) Alden Wells Monetary Report: "Mr. Nixon should, on taking the oath of office, have announced the immediate withdrawal of our armed forces in Southeast Asia and the end of the draft. The country was ready, and the killing would have stopped. Within his first 100 days he should have presented a comprehensive detailed foreign policy repudiating the rationale of Vietnam 'containment', and centered on the reality of the 'bomb'. Instead, by skirting around all foreign policy issues, he has now lost the ability to lead as surely as Johnson has."

From Traders Research Market Timing Service: "While the subject is fresh, we reflect on an estimate that the average American will need his entire Jan. 1 — April 27 income to meet his federal, state and local tax obligations for the current calendar year. Tax Foundation, Inc., calculates that it takes 117 days to meet the average tax bill: 81 days for the federal government plus 36 days for state and local obligations." Thank you Daniel Merkle of Traders Research, I would have been happier if I had never read this one.

From the International Harry Schultz Letter, April 17: "In Basel last weekend, BIS bankers pressed U.S. to apply U.S. bank rules to Euro-dollar borrowings. They object to the U.S. sucking money from Europe. Seems to have fallen on deaf ears. In my view, borrowed Euro-dollars will haunt the monetary system, crack it wide open when recalled to Europe (unless gold is hiked in time)."

Page 6 STOCKS: With only 37% of all N.Y.S.E. in bullish trends and with only 26% of these stocks holding above their 30-week moving averages, any cross-section of charts looks noticeably poor. Quote Digest (110 N. Lorraine, Wichita, Kansas) arranges charts of the whole N.Y.S.E. in alphabetical order. I picked the beginnings of the "B's" in the chart book to provide a typical look at the market (you guessed it, B is for bear).

Of the eight weekly charts shown on page 29 of this week's Quote Digest, all but two (BGE and BBO) are in bearish trends. This means that only 25% are bullish, vs. a total N.Y.S.E. reading of 37% bullish. Thus this page is fairly typical of what is occurring on the entire N.Y.S.E.

Collapses are depicted in BAW, BNK and BAT. Tops are formed in BKO, BCR and BAI. BNK and BAT have lost almost 50% of their value in the periods shown (roughly six quarters), while BAW and BAI have lost better than one-third their value.

On the whole, the market has provided some whopping losses as shown on these typical charts, and this is the reason why I have advised my readers to stay on the sidelines until this primary bear market runs its course.

As I see it, the second (psychological) phase of the bear market began at the October, 1966 lows, and almost all the action since then has been part of a great, deceptive secondary (upward) correction. The peak for the Dow Industrials during the upward part of the second phase came in late-1968 at 985.21. I would guess that the downward part of the second phase is now slowly moving underway. Where it will end, or when it will end, is anybody's guess, but our's is not a problem of guessing. It remains for us to stay liquid and on the sidelines until it is over. And it is not over yet.

BEARISH SIGNAL: Below is a point and figure chart of the Dow (courtesy of Chartcraft). All boxes represent 5 points on the Dow; only advances or declines of 15 points or more are depicted (vertical rows of X's represent advances, vertical rows of O's represent declines).

With the latest decline below 920, the Dow has provided a bearish signal. The 920 box is inked in solid black, showing the drop below the previous decline low. This is a bearish reversal signal. To me, it is significant that the recent action occurred below the descending or bearish trendline marked "Y" on chart, and also below the trendline marked "Z" on chart. A further and important bearish signal would arrive if the Dow closes at 895 or below, which would constitute a penetration of the double-bottom at 900 as shown on chart.